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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. [redacted] 139

WALTER F. TELLIER and EVELYN H. TELLIER,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	2
Statement	3
Reasons for Granting the Writ	8
Conclusion	22
Appendix A—Statutes	23
Appendix B—Opinion Below	29

Citations

Cases:

Bradford, J. C., 22 T. C. 1057 (1954)	15
Burgher v. Campbell, 244 F. 2d 863 (5th Cir. 1957)	15
Commissioner v. Burnett, 118 F. 2d 659 (5th Cir. 1941)	12
Farr, Francis Shelton, 44 B. T. A. 683 (1941)	11, 12, 18
Frank v. Commissioner, 321 F. 2d 143 (8th Cir. 1963)	15
Fuld v. Commissioner, 139 F. 2d 465 (2nd Cir. 1943)	15
Helvering v. Fried, 299 U. S. 175 (1936)	12

PAGE

Kemon, George R., 16 T. C. 1026 (1951), Acq. 1951-2 C. B. 3 ..... 13, 15

Marks & Co., Carl, 12 T. C. 1196 (1949), Acq. 1949-2 C. B. 3 13

Phipps v. Commissioner, 54 F. 2d 469 (2nd Cir. 1931) .. 15

Schaefer v. Helvering, 299 U. S. 171 (1936) 12, 13, 14

Stern Brothers & Co., 16 T. C. 295 (1951), Acq. 1951-2 C. B. 4 13

Stifel, Nicolaus & Co., 13 T. C. 755 (1949), Acq. 1950-1 C. B. 5 13

Van Suetendael v. Commissioner, 152 F. 2d 654 (2nd Cir. 1945) 11

Van Tuyl, E. Everett, 12 T. C. 900 (1949), Acq. 1949-2 C. B. 3 13

Vaughan v. Commissioner, 85 F. 2d 497 (2nd Cir. 1936), *cert. denied* 299 U. S. 606 12

Wood, Thomas E., 16 T. C. 213, 219-220 (1951), Acq. 1951-2 C. B. 4 10

Statutes:

United States Code:

Title 28 §1254(1) 2

Title 26 §6213 3

Internal Revenue Code of 1954:

Section 1237 16

Section 1236 ..... 2, 7, 17, 18, 20, 21

PAGE

Section 1236(a)(2) 18

Section 1221 ..... 2, 8, 14

Section 1221(1) 2, 6, 11

Section 1091 17

Section 543 17

Internal Revenue Code of 1939:

Section 117(a)(1)A 2, 6, 8, 11

Section 117(n) 2, 7, 13, 14, 15, 16

Revenue Act of 1934 ..... 9, 11

Revenue Act of 1932:

Section 23(r) 8, 9, 10, 11, 13

Revenue Act of 1924 ..... 8, 15

Regulations:

1954 Regulations:

Section 1.1236-1(d) 18

Section 1.543-1(b)(5) 17

Section 1.471-5 2

1939 Regulations:

Section 39.22(c)5 2

Regulations 45, Article 1585 11

PAGE

Miscellaneous:

H. R. Rep. No. 586, 82nd Cong., 1st Sess. (1951) 119—Section 309 13

H. R. Rep. No. 74, 73rd Cong., 2nd Sess. (1934) 9, 10; 1939-1 C. B. (Part 2) 561, 562 .....9, 10

H. R. Rep. No. 708, 72nd Cong., 1st Sess. (1932) 12-14, 1939-1 C. B. (Part 2) 465 (Section 23R), (S), (T), (U) and (V) Stock Losses 9, 12

S. Rep. No. 665, 72nd Cong., 1st Sess. (1932) 17-20, 1939-1 C. B. (Part 2) 510 12

In the

Supreme Court of the United States

October Term, 1964

No. .....

Walter F. Tellier and Evelyn H. Tellier,

Petitioners,

—v.—

Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on February 16, 1965.

Citations to Opinions Below

The memorandum opinion of the Tax Court of the United States (R. Vol. I, pp. 4a-30a) is unreported. The opinion of the Court of Appeals for the Second Circuit, printed in Appendix B hereto, *infra* pp. 29-42, is reported in 342 F. 2d 690.

Jurisdiction

The judgment of the Court of Appeals was entered on February 16, 1965 (R. Vol. II, p. 20). The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Questions Presented

1. Does the language of Section 1221 of the Internal Revenue Code of 1954, which excepts "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" from the definition of capital assets, represent the deliberate adoption of the Commissioner's definition of dealer's inventory with specific intent as part of an overall design for taxation to make the statutory exception applicable only to such stocks and bonds as may be inventoried?

2. Is Section 1236 of the Internal Revenue Code of 1954 an affirmation by Congress of a dealer's absolute right to privately invest in securities identical with those that constitute his inventory as a dealer in securities?

Statutes Involved

The statutes involved are Sections 1221(1) and 1236 of the Internal Revenue Code of 1954 and Sections 117(a)(1)(A) and 117(n) of the Internal Revenue Code of 1939. The Commissioner's Regulations involved are 1954 Regulations Section 1.471-5 and 1939 Regulations Section 39.22(c)-5. These are printed in Appendix A, hereto, *infra* pp. 23-28.

Statement

The jurisdiction of the Tax Court was invoked under Title 26 U. S. C. §6213.

In their petition to the Tax Court, petitioners alleged error in two determinations made by the Commissioner. These were: (1) that the Commissioner had erroneously taxed the proceeds of the sale of certain securities as ordinary income and ordinary loss, when, as a matter of law, these securities were without question capital assets because petitioner, Walter F. Tellier, was neither a dealer, nor were the securities dealer's stock in trade, as both terms were defined by law, and (2) that the Commissioner had erroneously disallowed a deduction for the payments made to counsel in an unsuccessful defense against an indictment based on acts committed by the petitioner as part of his business.

Before trial, the Commissioner amended his pleadings to contend that if his reason for taxing the proceeds of the sale of the securities at ordinary rates was determined by the Tax Court to be invalid, the profits (and losses) should nevertheless be taxed as he had previously determined, because the securities had in reality been received as a form of deferred compensation. The Tax Court approved both original determinations, but did not reach the contention raised by the Commissioner in his amended pleadings.

The Court of Appeals for the Second Circuit was petitioned for a review of both issues. A panel of three judges heard the argument, and affirmed the Tax Court's decision on the capital gain issue. The deduction issue, however, was considered *en banc,* and the eight judges, who participated, concurred in the reversal of the decision below. The Court is petitioned to grant a writ of certiorari for

the review of that part of the decision by the Court of Appeals which affirmed the Tax Court's decision on the capital gain issue.

On that issue, the Tax Court made the following findings:

During the period January 1, 1952, to May 11, 1956, petitioner, Walter F. Tellier, was the controlling and principal participant in a business known as Tellier and Company, which was registered with the Securities and Exchange Commission as dealers and brokers (R. Vol. I, p. 7a).

Tellier and Company acted as underwriters in the public sale of highly speculative stock offerings by corporations seeking funds for new business ventures (R. Vol. I, p. 7a). As underwriters, Tellier and Company acted as agents, receiving a selling commission of 25 percent of the proceeds. The contracts between the corporations and the underwriters also provided that Tellier and Company, or their nominee, for a nominal consideration, usually $100, could acquire stock purchase warrants covering stock equal to 25 to 100 percent of the amount offered to the public at prices equal to or in excess of the public issue price of such stock. The warrants were all nontransferable and nonexercisable for a 13-month period following the effective date of the filing of a letter of notification with respect to the public offering with the Securities and Exchange Commission (R. Vol. I, p. 92).

In every instance, the stock warrants were directly acquired by petitioner, and not by Tellier and Company (R. Vol. I, p. 92). The warrants had no readily ascertainable market value (R. Vol. I, p. 19a). There were also instances when petitioner acquired shares of stock from officers and directors of the same corporations for whom Tellier and

Company was acting as the underwriter (R. Vol. I, p. 14a). However, there was a distinction between the stock sold by Tellier and Company and the stock held by petitioner: the stock held by petitioner was unregistered and could not be sold to the public without the express prior authorization of the Securities and Exchange Commission (R. Vol. I, p. 10a). Petitioner's stock was frozen; Tellier and Company's was not.

Every security owned by the petitioners (whether regularly listed or a security here in issue) was issued in their individual names and also listed in a separate investment account maintained in the books and records of Tellier and Company (R. Vol. I, p. 9a).

Tellier and Company was active in the secondary market of the securities which Tellier and Company had initially sold to the public (R. Vol. I, p. 9a). However, in such further trading, Tellier and Company did not "make the market." The Tax Court said: "Once the public issuance was completed, Tellier and Company continued to trade in the stock, buying and selling for its own account" (R. Vol. I, p. 23a, Vol. III; Original Record, p. 174).

When Tellier and Company oversold any issue, petitioner would either lend their securities or sell such securities to the Company. However, with respect to the securities here involved, the prior consent of the Securities and Exchange Commission was required, and no such sale was made without the Commission's consent (R. Vol. I, p. 10a).

During the five taxable years involved, there were 70 sales transactions by petitioner involving the personally held securities of corporations for whom Tellier and Company had served as the underwriter of public issues. 37

of these were cleared through the facilities of Tellier and Company (R. Vol. I, pp. 22a, 23a). (Presumably, the Tax Court found that the remaining transactions were privately negotiated by petitioner.)

Petitioner had reported the net profits from the sale of all his privately owned securities as capital gain. The Commissioner, however, determined that those securities which had been issued by corporations for whom Tellier and Company had acted as underwriters were different and fell within the statutory exception from capital asset classification for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . ."

Petitioners urged the Tax Court to disapprove the Commissioner's determination for the following reasons:

(1) That the language of the statute (identical in both Internal Revenue Code of 1939, §117(a)(1)(A) and Internal Revenue Code of 1954, §1221(1)) excluding property held for sale to customers in the ordinary course of business constituted the adoption and incorporation of the Commissioner's Regulation which identified the stock in trade of a dealer for purposes of inventory,

(2) That, therefore, the statutory tests for determining whether or not securities are capital assets are those of the Regulations; viz., whether the taxpayer is a dealer and whether the securities are his stock in trade in his business as a dealer, as the terms are defined in the Regulations,

(3) That since the Commissioner made no contention that the securities, which he had taxed on the basis

that they had been held for sale to customers in the ordinary course of business, were inventoriable as dealer's stock in trade, and that since on the record, it was evident that those securities could not be inventoried, the Commissioner's determination was patently incorrect as a matter of law,

(4) That, regardless of the dealer question, petitioner was as a matter of law correct in classifying the securities as capital assets, because he had faithfully observed the requirements of Sections 117(n) and 1236 of the 1939 and 1954 Internal Revenue Codes, which Sections were designed to insure that a dealer be taxed at capital gain rates on securities identified in accordance with the statutes as held for personal investment.

The Tax Court held, as a matter of fact, that the securities had been held for sale to the customers of Tellier and Company with intent to obtain capital gain from the selling activities of Tellier and Company. The Tax Court did not respond to the contention that the issue required application of the Regulation's definitions of a dealer in securities and his stock in trade. Indeed, the Tax Court's use of the term "dealer" is ambiguous. With respect to the argument based on identification of the securities, the Tax Court ruled that the statute was inapplicable.

Petitioners thereafter asked the Second Circuit to reverse for the following reasons:

(1) That the Tax Court had ruled as a matter of fact, whereas the statute had established a rule of law.

(2) That the legislative history of the statute, uniform judicial construction and consistent administrative interpretation proved that the statute excepted only a security dealer's inventory from classification as capital assets.

(3) That under application of that construction, the Tax Court's decision was incorrect, even if all the findings of fact were granted *arguendo*.

(4) That the purpose and very language of the identification-for-private-investment statute disproved the Tax Court's ruling that such statute was inapplicable.

The affirmation by the Second Circuit is on the basis that there is ample evidence to support the Tax Court's finding of fact. The Second Circuit neither discussed nor ruled on the issues of law raised by petitioners in their petition for review.

Reasons for Granting the Writ

1. The Court should reverse a decision which destroys the ability of a statute to fulfill the important tax policy for which it was enacted by Congress:

A. The legislative history of subsection 117(a)(1)A of the Internal Revenue Code of 1939 (re-enacted in Section 1221 of the Internal Revenue Code of 1954) begins with the Section 23(r) of the Revenue Act of 1932. By that latter section, Congress interposed a drastic limitation on the unlimited deduction of losses resulting from the sale of stocks and bonds excepted from the capital asset definition in the Revenue Act of 1924. Thereby, Congress stemmed a severe drain on tax revenues which had been set off by the

depression of 1929. (H. R. Rep. No. 708, 72nd Cong., 1st Sess. (1932) 12-14, 1939-1 C. B. (Part 2) 465 (Section 23(R), (S), (T), (U), and (V), Stock Losses).)

In 1932, Congress, coping with a tax emergency created primarily by defects in the then existing pattern for taxation in connection with the losses that were resulting from the sale of stocks and bonds, addressed itself only to the situation prevailing in that area. Section 23(r), adopted in 1932, was, more or less, patch-work legislation. In the 1934 Act, however, Congress undertook to review the entire pattern of taxation.[1] The 1934 Act carried forward the

[1] H. R. Report No. 74, 73rd Cong., 2nd Sess. (1934) 9, 10; 1939-1 C. B. (Part 2) 561, 562:

"Existing law provides in section 101 for a special treatment of the gains and losses resulting from the sale of capital assets held over two years. The tax on gains on such sales is limited to 12½ per cent, with a corresponding limitation in case of losses. In the case of assets held less than two years, the gains are taxed in full and the losses allowed in full except in the case of stocks and bonds, losses from which are limited under section 23(r).

Our present system has the following defects:

First. It produces an unstable revenue—large receipts in prosperous years, low receipts in depression years.

Second. In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.

Third. Taxpayers take their losses within the 2-year period and get full benefit therefrom, and delay taking gains until the 2-year period has expired, thereby reducing their taxes.

Fourth. The relief afforded in the case of transactions of more than two years is inequitable. It gives relief only to the larger taxpayers with net incomes of over $16,000.

Fifth. In some instances, normal business transactions are still prevented on account of the tax.

Your committee has examined the British system, which disregards these gains and losses for income-tax purposes. The stability of the British revenue over the last 11 years is

limited accomplishments of the previous legislation and constituted a finished product of the labor of Congress to fashion a pattern of taxation (*Thomas E. Wood,* 16 T. C. 213, 219-220 (1951), Acq. 1951-2 C. B. 4) that "will result in greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, . . . will yield substantially greater revenue, . . ." and, yet, be ". . . safe from a revenue standpoint . . ." (H. R. Report No. 74, *supra*).

Section 23(r) of the 1932 Act had been made universally applicable to all taxpayers. Only one exception had been permitted: for a dealer in securities, and even with respect to a dealer in securities, the exception had been limited to only ". . . (. . . stocks and bonds acquired for resale to customers) in respect of [the dealer's] transactions in the ordinary course of his business . . .". Thus, the statute clearly stated that it was the policy of Congress to limit

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in marked contrast to the instability of our own. In that period the maximum British revenue was only 35 per cent above the minimum, while in our own case the percentage of variation was 280 per cent.

Your committee, however, has been unable to reach the conclusion that we should adopt the British system. It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed. Your committee recommends the following plan: * * *

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It is believed that the adoption of this plan (see section 117 of the bill) will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will yield substantially greater revenue. *The method proposed is safe from a revenue standpoint, inasmuch as capital losses can not be used to reduce ordinary income, while gains are taxed in full or in part in proportion to the time for which the property has been held.* The existing method which has been in force since 1921 can be defended only on the ground of expediency." (Emphasis added.)

the security losses of every taxpayer except those of dealers.

The same policy of limiting every taxpayer's ordinary deductions for losses incurred in the sale of securities was carried forward and made part of the 1934 Revenue Act. The policy was, however, expressed in a different manner—by an amendment to the capital asset definition that changed the exception for "property held by the taxpayer primarily for sale in the course of a trade or business" to "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." It is clear, therefore, that the 1934 amendment of the capital asset definition brought the specific key words and principles of Section 23(r)(3) directly into the 1934 Act, as the Tax Court so held in *Francis Shelton Farr*, 44 B. T. A. 683 (1941).

There has been no subsequent change in the language of that statutory exception. Consequently both Section 117(a)(1)A of the 1939 Code and Section 1221(1) of the 1954 Code state the continued policy of Congress, first expressed in Section 23(r) of the 1932 Act, to limit the escape of securities from the limitations of the capital gain and loss sections of the law into the haven of dealer's property. Carrying out that policy of Congress requires that the statutory exception from capital asset classification be strictly enforced and that is accomplished by a strict interpretation of the definition of "dealer." (Cf.: *Van Suetendael* v. *Commissioner*, 152 F. 2d 654 (2nd Cir. 1945).)

B. Ever since promulgation of Article 1585 of Regulations 45, the Commissioner has provided an unchanged definition of a security dealer for the purposes of regulating

a dealer's right to inventory securities for the computation of his annual gross income. The Committee Reports[2] accompanying the 1932 Revenue Bills quoted the language of that Article *verbatim* in explanation of the type of dealer transaction that was exempt from the operation of Section 23(r). In the light of the continuity of purpose of the 1932 and 1934 legislation, courts uniformly determined that in the 1934 Act, Congress had intended to limit the exception from capital asset classification solely to a dealer's stock in trade which he could inventory pursuant to the Commissioner's Regulation. *Commissioner* v. *Burnett,* 118 F. 2d 659 (5th Cir. 1941); *Francis Shelton Farr, supra.*

The Commissioner's Regulation, however, makes a distinction between the securities held by a taxpayer in his capacity as a dealer and those which he holds as an investor. According to the Commissioner's distinction, the dealer's stock in trade consists only of those securities which he stocks for the regular call of his customers and which he sells at a merchant's mark-up. The application of the Regulation by the courts to security markets' organization produced the inevitable conclusion that only the stock in trade actually used by the "specialist" broker in his specialist activity could qualify for inventorying under that Regulation. That specific rule was fully approved in *Schaefer* v. *Helvering,* 299 U. S. 171 (1936); *Helvering* v. *Fried,* 299 U. S. 175 (1936); and *Vaughan* v. *Commissioner,* 85 F. 2d 497 (2nd Cir. 1936), *cert. denied,* 299 U. S. 606.

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[2] H. R. Rep. No. 708, 72nd Cong., 1st Sess. (1932) 17-20; 1939-1 C. B. (Part 2) 466. The Senate Report (S. Rep. No. 665, 72nd Cong., 1st Sess. (1932) 17-20; 1939-1 C. B. (Part 2) 510) is substantially the same.

The *Schaefer* rule has been consistently used by the Tax Court to mark the line of distinction between dealer and investment security. *E. Everett Van Tuyl*, 12 T. C. 900 (1949), Acq. 1949-2 C. B. 3; *Carl Marks & Co.*, 12 T. C. 1196 (1949), Acq. 1949-2 C. B. 3; *Stifel, Nicolaus & Co.*, 13 T. C. 755 (1949), Acq. 1950-1 C. B. 5; *Stern Brothers & Co.*, 16 T. C. 295 (1951), Acq. 1951-2 C. B. 4; *George R. Kemon*, 16 T. C. 1026 (1951), Acq. 1951-2 C. B. 3. As a consequence, it has also become the firm rule that only securities, which may be inventoried under the Commissioner's Regulation, as annotated by *Schaefer* v. *Helvering, supra*, escape from capital asset classification. (*Ibid.*)

In 1951, Congress eliminated the difficulty, existing under the Regulations and under the *Schaefer* rule, in ascertaining the status of a security which a dealer had switched between his inventory and his investment account. Congress enacted Section 117(n) of the Revenue Act of 1939 to provide "rules" as guidelines.[3] Section 117(n), however, was still designed to operate within the poles of "inventory" and "investment account." Therefore, Congress has signified that the application of the rule of *Schaefer* correctly enforces the tax policy first established by Section 23(r) of the 1932 Act.

For the first time, however, the Tax Court now permits a security, which is not dealer's stock in trade, to escape from the limitations built into the capital asset classification. For the first time, the Tax Court now establishes a class of taxpayers who, though not dealers within the rule of *Schaefer* v. *Helvering, supra*, are, nevertheless, entitled

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[3] H. R. Report No. 586, 82nd Cong., 1st Sess. (1951) 119—Section 309.

to the full deduction of losses from the sale of securities. The Tax Court has therefore breached the statute at the point where it is most important to the fulfillment of the tax policy which it furthers. It opens the door to the full deduction of losses by the very taxpayers who took advantage of the 1929 depression to wipe out all of their income tax liability and against whose losses the statute was specifically amended to act as a bar.

2. The Court should reverse a precedent which dangerously encourages litigation and unsettles the law in every area in which identification as a dealer is a necessary requisite:

A. The combination of the changed definition (reenacted as Section 117(n) of the 1939 Code and Section 1221 of the 1954 Code) and the objective rule laid down in *Schaefer* v. *Helvering, supra,* serves to eliminate the causes for litigation because together they constitute a complete and sure method for identification, as a matter of law, of both the securities dealer and his inventory. The Tax Court now discards the rule of law and substitutes a test that is based on the factual situation of each case.

As respondent's brief urged that test upon the Court of Appeals, it is:

> "... whether property falls within the excepted category is to be resolved in the light of all circumstances bearing upon whether the activities of the taxpayer amounted to the carrying on of a business of selling, *no one factor being conclusive;* ... (at p. 10, emphasis added).

It is clear that the Tax Court has been persuaded to adopt a test that is both vague and uncertain; a test that

invites litigation, because it encourages a draconian philosophy in tax collection and a "take the risk" attitude in taxpayers.

As both the Tax Court's decision and respondent's supporting brief to the Court of Appeals amply demonstrate, the Tax Court has constructed a new test patched together from many cases, all of which, however, involved the dealer issue in real property sales, particularly in subdivision cases.[4]

Since these cases derive from decisions, which enforced the pre-1934 statute,[5] they cannot be deemed to be reliable precedents in connection with the test established by 1934 statute. It is immeasurably much more difficult to meet the 1934 test of property held primarily for sale to customers in the ordinary course of business than it was to meet the pre-1934 test of property simply held for sale in a business. *Fuld* v. *Commissioner,* 139 F. 2d 465 (2nd Cir. 1943).

However, the more significantly distinguishing feature in real property decisions is that in such controversies, the

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[4] The Tax Court cites no more than two authorities:

J. C. Bradford, 22 T. C. 1057 (1954), once it passes its special problem (not at all pertinent here, because of the subsequent enactment of section 117(n)), adheres completely to the Tax Court's previous position, now repudiated. *Burgher* v. *Campbell,* 244 F. 2d 863 (5th Cir. 1957) is a real property dealer case.

The Commissioner cites five authorities: four are real property dealer cases, and the fifth, *Frank* v. *Commissioner,* 321 F. 2d 143 (8th Cir. 1963) is apparently the model for the Tax Court's action here. It specifically rejects the authority of *George R. Kemon,* 16 T. C. 1026 (1951), Acq. 1951-2 C. B. 3, and substitutes a subjective opinion.

[5] Not unexpectedly, respondent cited *Phipps* v. *Commissioner,* 54 F. 2d 469 (2nd Cir. 1931) to support the Tax Court's decision. However, that case involved the application of the Revenue Act of 1924 to 1924 and 1925 tax liabilities.

courts have had to struggle without the assistance of definitive guides that could be applied as rules of law. Real property dealers do not inventory for the purpose of computing gross income, and there has been no need for a regulation in that respect. Consequently, there has never been an authoritative definition of a real property dealer or of a real property dealer's activities. Neither has there been the opportunity for the development of case-law annotations of such definitions. In real property dealer cases, courts have been forced to navigate uncharted waters.

More important, since the history of the legislation is so completely entwined with taxation experience in the specific area of securities transactions, it is absolutely impossible in connection with securities to misjudge either the intention of Congress or the correct application of the policy of Congress as it relates to that specific area. Whatever may be claimed with respect to the rule in real property cases, the legislative history of the statute clearly proves that the courts definitely have uniformly applied correct law in stock and bond cases.

Unlike the case of the securities dealer issue, which has since 1951 generated a minor amount of litigation, the real property dealer issue remains as a prolific source of controversy. Congress has not been uncritical. In the 1954 Code, Congress took the first step to establish rules of law for the determination of real property dealer status. Section 1237 of the Internal Revenue Code of 1954 parallels the effect of Section 117(n) of the Internal Revenue Code of 1939 to provide a rule of law in the case of subdivisions of real property.

In departing from the clear and unequivocal rules of law, which have been uniformly applied to determine securi-

ties dealer status and which are clearly correct interpretations of Congressional policy, to borrow a vague and uncertain test of dubious legality from another area, the Tax Court degrades the securities dealer issue to the litigation-breeding status of the real property dealer issue. That action is all the more unfortunate, since it produces a need for legislation in a situation where Congress has already definitively spoken twice.

Moreover, a clear, authoritative restatement of the law at this critical moment, when the first deviation has occurred, will also provide guidance for courts and litigants in those controversies which involve the real property dealer issue. Such restatement will eliminate the cause for much of the uncertainty of decision which now marks those latter cases and must result in a reduction of litigation in that area.

B. Congress has used the term "dealer" in many different sections of the Internal Revenue Code. For example: (1) Section 1091, prohibiting a deduction for a loss from a wash sale of stocks and bonds does not apply to a corporation, which "is a dealer in stocks and bonds, and the loss is sustained in a transaction made in the ordinary course of its business", (2) For the purposes of the tax on personal holding companies, Section 543 defines ordinary gross income as excluding "interest received on a direct obligation of the United States held for sale to customers in the ordinary course of a trade or business by a regular dealer who is making a primary market in such obligations",* and

* And in Regulations §1.543-1(b)(5) gain from the sale of securities includes the excess of gain over losses, "except in the case of regular dealers in stocks or securities" who, in turn, are defined as corporations with an established place of business who regularly purchase securities for resale to customers, but not to include the securities held in an investment account pursuant to section 1236.

(3) Section 1236, provides rules for the identification of a dealer's inventory and his investment account.

The fact that in all these instances (as well as in the case of the exception from capital asset classification here in issue), Congress has chosen language that parallels the language of the Commissioner's inventorying Regulation strongly suggests that the latter had served as a model for all of the former (Cf. *Francis Shelton Farr*, 44 B. T. A. 683 (1941)). At the least, so long as the Regulations and its case annotations could be accepted as authoritative interpretations for uniform application throughout the Code, no issue for litigation could arise.

That situation is no longer the case. The Tax Court, having rejected the principle of uniform application of definitions throughout the Internal Revenue Code, throws the language of different sections, though otherwise similar, into the arena of litigation for individual redefinition.

3. The Court should reverse the refusal of the Tax Court to give meaningful effect to Section 1236 of the Internal Revenue Code:

Section 1236 provides rules for the ascertainment of dealer's inventory and dealer's private investment stock. Very simply but accurately rephrased, the section says that if a dealer wants any part of his dealer inventory[7] clas-

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[7] The substitution of "inventory" for the language in section 1236(a)(2), "held by such dealer primarily for sale to customers in the ordinary course of his trade or business" is fully justified by the Commissioner's similar practice. Regulations §1.1236-1(d) reads as follows:

> Identification of security in dealer's records. (1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by making appro-

sified as private investment stock, he must adequately and timely identify it as such, and once such identification of a security has been made, the dealer may never deduct a loss from the sale of such security as an ordinary deduction against his other income.

It is plain that had the Tax Court but made an effort to apply the statute, it would have realized that its earlier refusal to equate "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" with inventory was a gross mistake of law. Instead, the Tax Court said that Congress had not intended to enlarge the definition of capital assets to allow the conversion of property (such as the Tax Court had already decided upon to rule to be dealer property) into capital assets. In short, the Tax Court said that it did not think that Congress had intended a definition different from the one to which the Tax Court had already committed itself.

The Tax Court gave no basis for its opinion: it merely dismissed the statute out of hand. It is, however, axiomatic that courts are under obligation not only to enforce statutes, but also to give them a meaning consistent with legislative intent.

Unfortunately, however, in summarily dismissing the statute to avoid the need to explain away the conflict be-

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priate entries in the dealer's books of account to distinguish the security from *inventories* and to designate it as an investment and by (i) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security, or (ii) adopting any other method of identification satisfactory to the Commissioner. (Emphasis added. Also see Rev. Rul. 64-160, 1964-1 C. B. (Part 1) 306.)

tween the obvious meaning of the statute and the ruling of the case, the Tax Court produced a precedent of far wider import than is easily apparent from the confines of this controversy. The Tax Court tied its ruling to the overall principles of what constitutes capital assets, thereby determining, not narrowly, that petitioner's securities fell within the exception, but that the securities were never, in the first instance, eligible as capital assets, regardless of the question of exception. The Tax Court has actually denied that petitioner's securities were capital assets at all; but if that were so, the entire issue of the exception would be academic and there would have been no reason for the Tax Court to have labored to take the securities out by way of an exception.

The Tax Court thus effectively struck away the foundation of Section 1236, which is the recognition by Congress that a dealer's securities have the capacity to be either capital assets or inventory at the sole option of the dealer. In denying that a dealer ever had that option, the Tax Court not only reversed its own well-established and long-existing rule, but also made the entire statute moot. For, if the dealer has not the right to freely decide which of his securities shall be inventory and which shall be investment securities, there is no point to a statute which purports to lay down the rules by which the dealer's choice can be definitively recognized.

In the circumstances of the Tax Court's decision, it is now impossible for a dealer (whether such by the definition of Section 1236 or by the Tax Court's newly established definition) to segregate and hold for private investment any security in which he deals. Yet, it is evident that dealers

do put away securities for investment and it is evident that the Tax Law has always recognized that such right has existed. The Tax Court's decision stands for a novel and unlawful precedent that a dealer cannot invest in any type of security which is found in his inventory as a dealer in that security. Consequently there is no field in which Section 1236 can operate.

4. The Court should grant the petition to preserve the right of litigants to a review of the issues which the litigants have presented, and to insure that the Courts of Appeals will provide teachings from which counsel can competently determine whether further appeal should be made:

The discretionary nature of the grant of petitions for a writ of *certiorari*, and the consideration by counsel for the time of the Court makes the petition for review in the various Courts of Appeals the final proceeding in the great majority of tax controversies. Hence, counsel and petitioners look to the Courts of Appeals for a careful and thorough examination of the controversy, including the consideration of the issues which petitioners themselves have presented for review.

In the Court below, petitioners charged that the decision of the Tax Court was mistaken as to law, and that on the basis of the findings made by the Tax Court itself, the decision was palpably incorrect. Petitioners' brief supplied the Court of Appeals with full legislative history and exhaustive case-law annotations of the statutes on which they relied. On oral argument, counsel disclaimed any purpose of requesting a reversal on the ground that the decision was not supported by the evidence. Nevertheless, the Court of Appeals affirmed on the ground that the Tax Court's decision was amply supported by the evidence.

It is plain that the opinion of the Court of Appeals fails to provide a decision on the only issue which petitioners had asked it to decide. Indeed, it is impossible to determine from the opinion what, if any, had been petitioners' allegation of error, nor the nature or dimensions of the argument that had been advanced to support that allegation of error.

That result is disappointing enough to petitioners, who become liable for a very substantial amount of tax without knowing for sure that a court of review has thoroughly considered their contentions. It is even more completely frustrating to counsel, whose duty it is to determine from the opinion of the Court of Appeals whether further appeal is justified. Counsel simply cannot make such a determination competently when the Court of Appeals has completely omitted any comment on the arguments which counsel had advanced.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

MICHAEL KAMINSKY
Counsel for Petitioners
122 East 42nd Street
New York, New York 10017

Of Counsel:

PATRICK H. SULLIVAN

APPENDIX A
Statutes

Internal Revenue Code of 1954:

§1221. Capital asset defined.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . .

• • • • •

§1236. Dealers in securities.

(a) Capital gains.

Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—

(1) the security was, before the expiration of the 30th day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) the security was not, at any time after the expiration of such 30th day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(b) Ordinary losses.

Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in section 582(c), (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment.

(c) Definition of security.

For purposes of this section, the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

Internal Revenue Code of 1939:

§117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . .

* * * * *

(n) Dealers in Securities.—

(1) Capital Gains.—Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—

(A) the security was, prior to the expiration of the thirtieth day after the date of its acquisition or after the date of the enactment of the Revenue Act of 1951 (whichever is the later), clearly identified in the dealer's records as a security held for investment; and

(B) the security was not, at any time after the expiration of such thirtieth day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(2) Ordinary Losses.—Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in subsection (i) (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after the thirtieth day following the date of the enactment of the Revenue Act of 1951 the security was clearly identified in the dealer's records as a security held for investment.

(3) Definition of Security.—For the purposes of this subsection the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

Regulations

1954 Regulations.

§1.471-5. Inventories by dealers in securities.—A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of §1.446-1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or

hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.

1939 Regulations.

§39.22(c)-5. Inventories by dealers in securities. A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in §39.41-2. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to

customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 29—September Term, 1964.

(Argued October 8, 1964 Decided February 16, 1965.)

Docket No. 28823

WALTER F. TELLIER and EVELYN H. TELLIER,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

LUMBARD, *Chief Judge,*
HAYS and ANDERSON, *Circuit Judges.*

Petition for review of a decision of the Tax Court, Scott, *Judge,* T. C. Memo. 1963-212, 22 CCH Tax Ct. Mem. 1062, insofar as that decision found that income from the sale of certain securities was taxable as ordinary income because the securities were held for sale to customers in the ordinary course of business, Section 117(a)(1)(A) of the Internal Revenue Code of 1939 (Section 1221(1) of the 1954 Code).

Affirmed as to this issue.

Before:

LUMBARD, *Chief Judge*,
WATERMAN, FRIENDLY, SMITH, KAUFMAN,
HAYS, MARSHALL and ANDERSON, *Circuit Judges*.

Petition for review of the same decision of the Tax Court insofar as that decision disallowed deductions under Section 162(a) of the Internal Revenue Code of 1954 for attorneys' fees incurred in an unsuccessful criminal defense.

Reversed as to this issue.

MICHAEL KAMINSKY, New York, N. Y. (Whitman, Ransom & Coulson, on the brief), *for Petitioners*.

ROBERT A. BERNSTEIN, Attorney, Department of Justice, Washington, D. C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson, Harry Baum, Attorneys, Department of Justice, of counsel), *for Respondent*.

HAYS, *Circuit Judge*:

I.

The first issue in this case is whether the profits realized from the sale by the taxpayer (Evelyn H. Tellier is a party only because she and her husband filed a joint return) of certain securities during the years 1952-1956 were taxable as ordinary income rather than as capital gain. The resolution of this issue turns upon whether the securities were held by the taxpayer for sale to customers in the ordinary course of his business of underwriting and selling securities.

If they were so held, then under Section 117(a)(1)(A) of the 1954 Code[1] the profits were taxable as ordinary income.

There is ample evidence to support the Tax Court's finding that the taxpayer held the securities for sale in the ordinary course of business. The taxpayer was engaged through Tellier and Company, in form a partnership but in fact wholly controlled by the taxpayer, in the business of underwriting the public sale of stock offerings and in purchasing securities for resale to customers. In connection with the underwriting agreements the taxpayer himself received stock or stock warrants which he sold, frequently through Tellier and Company.

There were seventy separate transactions of this kind during the years in question and the net gains from these sales were:

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1 Int. Rev. Code of 1939, §117:

"CAPITAL GAINS AND LOSSES.

(a) Definitions.—As used in this chapter—

(1) Capital assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . ."

Int. Rev. Code of 1954, §1221:

"CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . ."

1952	$74,755.33
1953	74,089.23
1954	49,184.05
1955	97,864.12
1956	13,277.42

On some occasions as an inducement to make more sales of the publicly issued shares, taxpayer would give Tellier and Company's salesmen a part of his stock warrants. Tellier and Company had at all times free call upon the securities which taxpayer kept in an "investment account." The cashier of Tellier and Company had authority to borrow any security it might need either because of a short sale or because a security was not received.

In the words of the Tax Court:

> "The volume of sales, petitioner's activities with respect to the securities, and the close relationship between petitioner's investment accounts and the dealing activities of Tellier and Company support the conclusion that the securities here involved were being held by petitioners for sale to customers in the ordinary course of their trade or business."[2]

Affirmed.

HAYS, *Circuit Judge* (with whom Chief Judge Lumbard, Judges Waterman, Friendly, Smith, Kaufman, Marshall and Anderson concur):

II.

The second issue presented in this case is whether legal expenses for the unsuccessful defense of a criminal action are deductible. We have decided that this problem, though

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2 T. C. Memo. 1963-212, 22 CCH Tax Ct. Mem. 1062, 1069.

long considered as authoritatively answered in this Circuit, should be reexamined.[3]

Taxpayer was tried and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933,[4] with violations of the mail fraud statute,[5] and with conspiracy to violate these statutes.[6] He was sentenced to four and one-half years of imprisonment on each count, the sentences to run concurrently, and was fined $18,000. He claimed a deduction in 1956 in the amount of $22,964.20, representing expenditures during that year incurred in his defense in the criminal proceeding. The Commissioner disallowed this deduction and his ruling was sustained by the Tax Court.

In disallowing a deduction for the expenses of an unsuccessful defense of a criminal action the tax authorities are following a purely judge-made rule. There is nothing in the statute which dictates or even suggests such a result. The applicable provision is Section 162 of the 1954 Code which provides:

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

There is no provision which expressly prohibits the deduction of the expenses of an unsuccessful defense. The general prohibition on deductions, Section 262, reads:

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3 After the appeal on this issue was heard by a panel consisting of Chief Judge Lumbard and Circuit Judges Hays and Anderson, the qualified judges of this Court agreed that the appeal should be considered *en banc*.

The appeal brought into question a principle which heretofore had been well settled by a prior decision of this Court. It was felt that we should reverse a previous categorical ruling of the Court only by vote of all the qualified circuit judges considering the question *en banc*.

4 §17, 48 Stat. 84 (1933), as amended, 15 U. S. C. §77q(a) (1958).

5 18 U. S. C. §1341 (1958).

6 18 U. S. C. §371 (1958).

"Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

That the framers of the legislation did not intend that it should be used for moral reform is indicated by the following bit of legislative history: In the Senate debate over the provision with respect to business losses, objection was raised to its liberality. It was suggested that deductions for losses be permitted only when incurred in a "legitimate" trade or business. The suggestion was rejected. Senator Williams, who was in charge of the income tax sections of the bill, explained that the object of the bill was

"to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters, that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year." 50 Cong. Rec. 3849 (1913).

In 1951 Congress rejected a proposal for disallowing deductions under Section 162 "for any expense paid or incurred in or as a result of illegal wagering" on the ground that the Internal Revenue Code was not intended to penalize or prohibit unlawful activities.[7]

Randolph Paul said:

"As exploration of relevant Congressional debates indicates, Section 23(a)(1)(A) [Section 162(a)] is not an essay in morality, designed to encourage virtue and

7 97 Cong. Rec. 12230-44 (1951).

discourage sin. It 'was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts.' Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business. . . . There is no evidence in the Section of an attempt to punish taxpayers . . . when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates 'in a vacuum,' if it serves its own vital function and leaves other problems to other statutes. When Congress has wished to deny tax deductions as a means of reinforcing the sanctions of other federal statutes, it has done so deliberately and explicitly." [8]

No Supreme Court case lends any support to the rule that the legal expenses of an unsuccessful criminal defense when paid or incurred in connection with the carrying on of a trade or business are not deductible. In fact the Court has cast doubt on the rule by what it has said with respect to the reasons ordinarily given to justify the existence of the rule. These reasons are: first, that the expenses occasioned by unlawful activities are not ordinary and necessary in the conduct of a business[9] and second that the allow-

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8 *The Use of Public Policy by the Commissioner in Disallowing Deductions,* Proceedings Tax Inst. Univ. of So. Calif. School of Law 715, 730-31 (1954), quoting Member Sternhagen, dissenting in *Burroughs Bldg. Material Co.,* 18 B. T. A. 101, 105 (1929), aff'd, 47 F. 2d 178 (2d Cir. 1931). (Footnotes omitted.)

9 See, e.g., *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878, 880-81 (2d Cir. 1937).

ance of a deduction for such expenses would be contrary to public policy.[10]

Of the legal expenses of resisting issuance by the Postmaster General of a fraud order, the Court said in *Commissioner* v. *Heininger*, 320 U. S. 467, 470, 471, 472 (1943):

> "There can be no doubt that the legal expenses of respondent were directly connected with 'carrying on' his business. . . .
>
> "It is plain that respondent's legal expenses were both 'ordinary and necessary' if those words be given their commonly accepted meaning. For respondent to employ a lawyer to defend his business from threatened destruction was 'normal'; it was the response ordinarily to be expected. Cf. *Deputy* v. *du Pont*, 308 U. S. 488, 495 [1940]; *Welch* v. *Helvering*, 290 U. S. 111, 114 [1933]; *Kornhauser* v. *United States*, [276 U. S. 145 (1928)] . . . . Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore 'necessary.' . . .
>
> "To say that . . . the expenses . . . were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world."

To the extent that the equation of illegality with extraordinary and unnecessary is not question begging, it is applying special meanings to "ordinary and necessary" which are not applied in other connections. So long as the expense arises out of the conduct of the business and is a required outlay it ought to be considered ordinary and necessary.

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10 See, e.g., *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (2d Cir. 1931).

As to public policy the Supreme Court held in *Lilly* v. *Commissioner*, 343 U. S. 90, 96-97 (1952):

> "Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as 'ordinary and necessary' expenses under §23(a)(1)(A) [Section 162(a)] when they 'frustrate sharply defined national or state policies proscribing particular types of conduct,' . . . nevertheless the expenditures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them." [11]

There has been no "governmental declaration" of any "sharply defined" national or state policy or discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge. In fact it is highly doubtful whether such a public policy could exist in the face of the Sixth Amendment's guaranty of the right to counsel.[12]

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11 Quoting *Commissioner* v. *Heininger*, 320 U. S. at 473. See also *Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U. S. 30 (1958); *Commissioner* v. *Sullivan*, 356 U. S. 27 (1958).

12 See *Powell* v. *Alabama*, 287 U. S. 45, 68-69 (1932):

> "The right to be heard would be, in many cases, of little avail if it did not comprehend the right to be heard by counsel. Even the intelligent and educated layman has small and sometimes no skill in the science of law. If charged with crime, he is incapable, generally, of determining for himself whether the indictment is good or bad. He is unfamiliar with the rules of evidence. Left without the aid of counsel he may be put on trial without a proper charge, and convicted upon incompetent evidence, or evidence irrelevant to the issue or otherwise inadmissible. He lacks both the skill and knowledge adequately to prepare his defense, even though he have a perfect one. He requires the guiding hand of counsel at every step in the proceedings against him. Without it, though he be not guilty, he faces the danger of conviction because he does not know how to establish his innocence."

The rule of disallowance of legal expenses in the case of unsuccessful defenses has been adversely criticized by numerous commentators.[13]

Adherence to the rule has led to anomalous, arbitrary, artificial and conflicting results. The attempt to apply a rule which seeks to distinguish between civil and criminal liability and successful and unsuccessful defenses has caused repeated difficulty in borderline cases. A disbarment proceeding, for example, has been classified as criminal and the legal expenses disallowed.[14] Legal expenses paid in behalf of an employee who was found guilty of violating certain sections of the California administrative code relating to horse-racing and who, as a result, lost his license as a trainer, were held deductible, but the court said that had the employee paid his own expenses they "probably" would not have been deductible by him.[15] A taxpayer was permitted to deduct attorney's fees in connection with settlement of a civil liability for assault,[16] while another taxpayer's legal expenses in defending an action for defrauding the government were disallowed.[17] When the taxpayer finally

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13 See, e.g., Arent, *Inequities in Non-Deductibility of Fines, Penalties, Defense Expense*, 87 J. Accountancy 482, 485-86 (1949); Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241 (1957); Keesling, *Illegal Transactions and the Income Tax*, 5 U. C. L. A. L. Rev. 26, 33-40 (1958); Paul, *supra* note 7; Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—a Critique*, 17 Fed. B. J. 575 (1957); Stapleton, *The Supreme Court Redefines Public Policy*, 41 Taxes 641 (1952); Note, *Public Policy and Federal Income Tax Deductions*, 51 Colum. L. Rev. 752, 756-58 (1951); Note, *Deduction of Business Expenses: Illegality and Public Policy*, 54 Harv. L. Rev. 852, 854-57 (1941); Comment, *Business Expenses, Disallowances, and Public Policy*, 72 Yale L. J. 108, 132-36 (1962).

14 *Estate of G. A. Buder*, T. C. Memo. 1963-73, 22 CCH Tax Ct. Mem. 300, aff'd on other issues, 330 F. 2d 441 (8th Cir. 1964).

15 *Robert S. Howard*, 32 T. C. 1284, 1296 (1959).

16 *John W. Clark*, 30 T. C. 1330 (1958).

17 *David E. Faulk*, 26 T. C. 948 (1956).

pleaded *nolo contendere,* the legal expenses of an unsuccessful trial and a successful appeal (i.e., successful in securing a new trial) were disallowed.[18] Legal fees expended in an unsuccessful attempt to avoid a prosecution resulting in conviction are not deductible.[19] Where a taxpayer pleaded *nolo contendere* to an indictment for tax evasion and the Tax Court later found that there was no fraud or fraudulent evasion for the years in question, the legal expenses connected with the indictment were held to be non-deductible.[20] On the other hand, legal expenses in connection with an unsuccessful defense against civil liability for taxes are deductible even where a fraud penalty is assessed.[21] The Commissioner disallows legal expenses in government actions under the antitrust laws but allows deduction of such expenses in private actions.[22]

This is the first occasion that we have had since *Heininger* and *Lilly* to reexamine our rule as to deductibility of legal expenses for an unsuccessful defense connected with the carrying on of a trade or business. We hold, following *Heininger,* that such expenses are ordinary and necessary within the meaning of the statute. We find no sharply defined public policy against the allowance of such deductions, as is required by *Lilly.* We therefore refuse to continue to draw any distinction in deductibility between civil and criminal cases or between successful and unsuccessful defenses. We hold that legal expenses are deductible where they arise out of and are immediately or proximately con-

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18 *Standard Coat, Apron & Linen Serv.,* 40 T. C. 858 (1963).

19 *Tracy* v. *United States,* 284 F. 2d 379 (Ct. Cl. 1960). *But see Commissioner* v. *Schwartz,* 232 F. 2d 94 (5th Cir. 1956).

20 *Bell* v. *Commissioner,* 320 F. 2d 953 (8th Cir. 1963).

21 *Hopkins* v. *Commissioner,* 271 F. 2d 166 (6th Cir. 1959).

22 Rev. Rul. 64-224, 1964 Int. Rev. Bull. No. 33, at 13.

nected with, and are required for, the conduct of a trade or business.

Reversed.

MOORE, *Circuit Judge*, took no part in the consideration or decision of this case.

LUMBARD, *Chief Judge*, with whom WATERMAN and KAUFMAN, *Circuit Judges*, join (concurring):

While concurring in Judge Hays' opinion for the court, I wish to add a brief word. In our decision in *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178, 180 (1931), we disallowed expenses incurred in the unsuccessful defense of criminal charges on the ground that to do so would be contrary to public policy. In my opinion, there is no present basis for the claim that such disallowance is consistent with public policy; on the contrary, it seems clear to me that public policy now requires us to allow the deduction.

Since *Burroughs* was decided, the federal courts have given fuller meaning to the Sixth Amendment, which guarantees to every defendant the right to be represented by counsel.

In 1938 the Supreme Court held in *Johnson* v. *Zerbst*, 304 U. S. 458, that counsel must be furnished an accused who is financially unable to retain his own counsel to defend him on federal charges. A few months ago Congress at long last realized that the right to counsel has little substance unless counsel is paid for his efforts and reimbursed for necessary expenses. Under the provisions of the Criminal Justice Act, 18 U. S. C. §3006(a), which became law on August 20, 1964, a defendant who is found to be financially unable to provide counsel and defray defense expenses is

now entitled to have such reasonable and necessary expenses paid by the government up to specified maximum amounts.

The assignment and compensation of counsel under the Criminal Justice Act do not depend on whether a defendant successfully asserts his innocence. Indeed, almost all of counsel's labors ordinarily must be done and his expenses must be incurred before guilt or innocence is finally established. The defendant has the right to put the government to its proof, if he so elects. His right to counsel does not depend upon whether in fact he has a defense or whether it was reasonable to contest the charges. Surely it needs no argument to support the proposition that unless a defendant has the benefit of counsel who can give necessary attention to the charges and their defense—and in cases such as Tellier's, this is usually a considerable task for conscientious counsel—he may not be in a position to make an intelligent and knowing decision as to whether or how to conduct a defense. Moreover, whether he stands trial or pleads guilty, he needs counsel who has thoroughly familiarized himself with the case and who can plead for his client in the light of such knowledge. If the compensation of counsel under the Criminal Justice Act does not depend on the success of the defense, it would seem to follow that the allowance of the deduction should not depend on the outcome in cases where the defendant is able to and does assume the financial burden of defending against criminal charges.

In holding that a financially able defendant may deduct as "ordinary and necessary" expenses the legal fees and expenses incurred in an unsuccessful defense, we are being consistent with a clearly evinced policy that a defendant be represented by counsel regardless of the ultimate success or failure of his defense.

As there is no provision of the tax laws which requires a contrary result, I agree that we should not impose an additional penalty on financially able defendants by refusing a deduction in such cases. The allowance of the deduction here sought is consonant with public policy and ought to be allowed. I think the teaching of *Johnson* v. *Zerbst, supra, Gideon* v. *Wainwright*, 372 U. S. 335 (1963), and the Criminal Justice Act requires this result and that we are no longer bound by *Burroughs*.

WATERMAN, *Circuit Judge* (concurring):

I concur in Judge Hays' opinion and I also concur in Chief Judge Lumbard's additional separate concurrence.

KAUFMAN, *Circuit Judge* (concurring):

I concur in the opinions of both Judge Hays and Chief Judge Lumbard.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 139

WALTER F. TELLIER AND EVELYN H. TELLIER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The issue presented by this petition [1] is essentially one of fact—whether securities sold by petitioner [2]

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[1] The petition is addressed to the first of two issues litigated below. The second issue was resolved in favor of the petitioner by the court of appeals and the Commissioner's time to file a petition for a writ of certiorari has been extended to June 16, 1965.

[2] Petitioner's wife is a party only because she and her husband filed joint returns.

were held primarily for sale to customers in the ordinary course of petitioner's business, thus making the gains on sale ordinary income rather than capital gain. The Tax Court found for the goyernment and the Court of Appeals for the Second Circuit affirmed (Pet. 29-32, R. 4a-30a).[2]

From 1945 to 1956, first as an individual and later as controlling (90%) partner in Tellier and Company, petitioner was in the business of underwriting securities sold to the public for less than $1 per share and purchasing securities for resale to customers. Pursuant to the underwriting agreements, Tellier and Company "nominated" petitioner to receive stock or stock warrants from the companies whose stock was being underwritten. Petitioner frequently sold these warrants or shares of stock through Tellier and Company (Pet. 31; R. 5a-9a). There were seventy separate transactions of this kind during the years 1952-1956 (the taxable years here in question) from which petitioner's annual profits varied between $13,000 and $97,000 (Pet. 31-32; R. 10a-19a). On some occasions, as an inducement to make more sales of the publicly issued shares, taxpayer gave Tellier and Company's salesmen part of his stock warrants. Tellier and Company at all times had free call upon the securities which taxpayer kept in what was designated by him as an "investment account." The cashier of Tellier and Company had authority to borrow any security it might need either because of a

[2] "R" references are to the appendix to the petitioner's brief in the court of appeals.

short sale or because a security had not been received (Pet. 32; R. 9a-10a).

Section 1221(1) of the Internal Revenue Code of 1954 (like its identical predecessor) excludes from classification as capital assets any "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The capital gains tax is designed to give preferential tax treatment to profits arising from investments, as distinguished from the profits of everyday business operations. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52. In order to effectuate this purpose "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." *Ibid.* The Tax Court sustained the Commissioner's determination that the gains from the securities sold by the taxpayer were taxable as ordinary income, rather than as capital gains, on the ground that (Pet. 32):

> The volume of sales, petitioner's activities with respect to the securities, and the close relationship between petitioner's investment accounts and the dealing activities of Tellier and Company support the conclusion that the securities here involved were being held by petitioners for sale to customers in the ordinary course of their trade or business.

The court of appeals affirmed, stating that "There is ample evidence to support the Tax Court's finding that the taxpayer held the securities for sale in the ordinary course of business" (Pet. 31).[4]

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[4] Neither court found it necessary to reach the government's alternative argument that petitioner's profits were in the

Petitioner does not challenge these findings of fact. Instead he argues that as a matter of law Section 1236 of the 1954 Code compels capital gain treatment for any stocks that a securities dealer has labelled an investment (Pet. 18-21). The argument is without merit. As is plain from its language and history, Section 1236 (like its identical predecessor) was intended to narrow, not to broaden the category of securities gains that would qualify for capital gain treatment. It expressly applies only if (1) the security was *not* held primarily for sale to customers, and (2) the security was clearly identified in the dealer's records as held for investment. The section is inapplicable if *either* of these two requirements is not met. As the Senate Finance Committee Supplemental Report stated:

> the mere fact that a security, which is actually held by the dealer for sale to customers in the ordinary course of the trade or business, is identified as required by this section as a security held for investment, will not cause the gain from the sale of the security to be treated as capital gain. [S. Rep. No. 781, Part 2, 82d Cong., 1st Sess., p. 47 (1951-2 Cum. Bull, 545, 577).]

Since both courts below found that the securities involved in the instant case were held primarily for sale to customers in the ordinary course of petitioner's

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nature of compensation for personal services. Cf. Treas. Regs. §§ 1.61-15, 1.421-6.

business, petitioner derives no benefit from Section 1236.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Solicitor General.

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ROBERT A. BERNSTEIN,
Attorneys.

JUNE 1965.

END